Mini-Review

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TAX EXPENDITURES AND PUBLIC POLICY

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TAX EXPENDITURES AND PUBLIC POLICY

INTRODUCTION

A tax expenditure is a selective tax measure that favours taxpayers in a given situation or that encourages them to behave in a way deemed desirable by the government. It generally takes the form of a deduction or exemption, an abatement, a tax deferral, lowered tax rates, or a tax credit. These measures are regarded as tax expenditures if they involve a change in the established tax base or a deviation from a recognized taxation benchmark.

Such preferential tax measures have significant consequences in three areas. First, horizontal equity: for example, the owner-occupier is favoured over the tenant of identical accommodation, if the value of the rent that the owner-occupier theoretically pays to himself is considered part of his total income. Second, vertical equity: non-taxation of capital gains favours high-income taxpayers and thus makes the tax system more regressive. And third, economic efficiency: non-taxation of services affects consumer choices and can make the economy less efficient.

DIFFICULTY OF DEFINITION AND LACK OF POLITICAL INTEREST

The increase in tax expenditures at the end of the 1970s can be explained by the growing budgetary restrictions that governments then found themselves facing. Direct spending had to be reduced; therefore, tax expenditures were adopted as a substitute, in the hope of achieving the objectives that had been set. In the early 1980s, the economic downturn forced the Canadian government to introduce incentives for investment and

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economic activity. At the same time, the government was under pressure to make the tax system more progressive, with a view to redistributing the country's wealth.

The debate over tax expenditures has been going on since 1968. In that year, Stanley Surrey proposed that governments regularly publish their tax expenditure accounts. According to him, tax expenditures are simply spending programs administered through the tax system, which ought to be treated in the same way as direct budget expenditures. Tax expenditures are difficult to administer and to monitor: they have no real ceilings, they are exempt from periodic review and public scrutiny, and in many cases they are administered by departments with no taxation expertise, which makes the sound allocation of public resources very difficult. They also add to the complexity of the tax system.

Since Surrey published his critique, ten OECD countries have published tax expenditure accounts. Five of them (Austria, France, Spain, the United States and West Germany) have passed laws requiring that such accounts be published. Canada published tax expenditure accounts in 1979, 1980 and 1985 (see appended table). The Office of the Auditor General, the Standing Committee on Public Accounts, and the Senate Committee on Banking, Trade and Commerce have all called for integration of tax expenditures into the budget process, and for their regular publication.

The taxation authorities' resistance to these repeated calls is not difficult to understand. Experts in this area do not agree on the standard against which tax expenditures should be defined. The choice is a highly subjective exercise. Some believe we should use the expanded tax base defined by Haig-Simmons, which corresponds to the sum of the value of consumption and net accretions in wealth. Any deviation from this norm would be defined as a tax expenditure. In 1966, the Carter Commission proposed using a tax base of this type, but this is scarcely feasible given that unanimity would be required for its definition (what distinguishes a tax expenditure from a budget expenditure?). Some experts believe we should make a distinction between tax transfers and tax expenditures. Furthermore, the standard has to meet the criterion of administrative simplicity - the difficulty of taxing imputed rent in the case of

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owner-occupiers illustrates the problem very clearly. Others propose the use of generally accepted accounting principles to define deviations from the norm. The difficulty of defining tax expenditures thus explains, in part, their exclusion from the budget process.

According to Bruce Doern, there is no a priori selection of particular tax expenditures: rather, overall tax choices are made within the budget process. Moreover, decisions on tax expenditures are now decentralized (that is, they are no longer the exclusive responsibility of the taxation authorities but are shared with other departments), and the involvement of the departments of Finance and Revenue has decreased. The lack of openness with respect to tax expenditures is of no concern politically, and it is not on the government's agenda.

Because tax expenditures have little political priority, the decisionmakers should bear in mind that such expenditures are only one of a number of ways that they can reach their objectives. Consequently, it does not matter a great deal whether or not they decide to call "tax expenditure" a loss of tax revenue. What they must try to determine is whether or not this tax choice is the most effective way of achieving the objectives that have been set.

CONCLUSION

Experience shows that publishing tax expenditure accounts may not have much effect on political decisionmaking. Elected representatives in the five OECD countries with the legislated obligation to publish such accounts are not called upon to vote on the accounts. In the United States, in particular, the impact of published tax expenditures on the budget process has been minimal. There is no political pressure to establish a distinction between tax expenditures and direct spending, and still less is there a consensus on their respective roles. Furthermore, the wrangling in Congress reduces to nil any possible influence from tax expenditure accounts.

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The government of Canada should nevertheless review its position on non-publication of tax expenditure accounts. If it really wants to reduce budget expenditures and the deficit, it will have to take a second look at foregone tax revenues. The Department of Finance has, it is true, put together a group of officials to study the justification for tax expenditures, but greater openness would ensure real commitment on the government's part. Given that Canada's whole tax system is being overhauled, the time may be ripe for this kind of choice.

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EXAMPLES OF TAX EXPENDITURES

	1979	1980	1981	1982	1983
		(millions of dollars)			
Personal Income Tax					
Political contribution tax credit	6	6	5	6	8
$1,000 investment income deduction	620	740	905	950	835
Tax advantage on RPPs and RRSPs	2,950	3,450	3,950	4,600	4,900
Marital exemption	1,015	1,055	1,115	1,220	1,385
Child tax credit	935	1,040	1,070	1,515	1,435
Deductibility of charitable donations	360	405	460	485	515
Corporate Income Tax					
Excess of tax depreciation over book depreciation	1,380-2,090	2,000-2,280	1,725-2,215	n.d.	n.d.
Allowable business investment losses	0-1	1-3	6-8	n.d.	n.d.
Small business deduction	1,020-1,065	1,255-1,310	n.d.-1,250	1,370	n.d.
Manufacturing and processing deduction	455-485	440-480	n.d.-425	330	n.d.
R&D tax credit	n.d.-430	n.d.-490	n.d.-445	390	n.d.

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EXAMPLES OF TAX EXPENDITURES (cont'd)

	1979	1980	1981	1982	1983
		(millions of dollars)			
Commodity Tax					
Exemption of transportation equipment	260	250	310	220	235
Sales tax exemption for small manufacturers (less than $50,000 of taxable sales)	20	20	25	25	25
Reduced sales tax on building materials and equipment	395	415	480	405	430
Exemption - food and non-alcoholic beverages	1,800	2,000	2,265	2,450	2,580
Exemption - clothing and footwear	525	575	640	665	705

Source: Department of Finance. Account of the Cost of Selective Tax Measures. Ottawa, 1985.